

ATLANTIC RICHFIELD CO. (ON RECONSIDERATION)

IBLA 87-173 Decided August 21, 1989

Petition for reconsideration of Atlantic Richfield Co., 105 IBLA 218, 95 I.D. 235 (1988), which set aside and remanded a decision of the Montana State Office, Bureau of Land Management, upholding a Miles City District Office decision assessing compensatory royalty for oil and gas drained from lease M-60749.

Petition granted; prior decision affirmed.

1. Oil and Gas Leases: Compensatory Royalty -- Oil and Gas Leases: Drainage

The prudent operator rule limits the duty of a common lessee to protect Federal lands from drainage, i.e., a common lessee must pay compensatory royalty on oil and gas that it drained from a Federal lease only if the reserves recoverable by a protective well on the Federal lease are sufficient to pay a reasonable profit over and above the cost of drilling and operating the well.

APPEARANCES: Mary Katherine Ishee, Esq., Paul B. Smyth, Esq., L. Poe Leggette, Esq., Office of the Solicitor, Washington, D.C., and Roger W. Thomas, Office of the Field Solicitor, Billings, Montana, for the Bureau

of Land Management; Gregory J. Nibert, Esq., Roswell, New Mexico, for appellant.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

By order of May 12, 1989, the Director, Office of Hearings and Appeals, granted a request by the Bureau of Land Management (BLM) to direct this Board to reconsider Atlantic Richfield Co., 105 IBLA 218, 95 I.D. 235 (1988). Prior to this order, BLM had filed a petition for reconsideration with the Board, but the Board denied it as untimely. See Order of February 8, 1989. Pursuant to the Director's May 12, 1989, order, we reexamine the merits of this appeal.

Atlantic Richfield Co. held that the prudent operator rule limits the duty of a common lessee to protect Federal lands from drainage, i.e., a common lessee must pay compensatory royalty on oil and gas it drains from a Federal lease only if the reserves recoverable by a protective well on the Federal lease are sufficient to pay a reasonable profit over and above the cost of drilling and operating the well.

The Federal lease in question, M-60749, is located within the N 1/2 of sec. 5, T. 31 N., R. 59 E., Montana Principal Meridian. The lessee, Atlantic Richfield Company (ARCO), is also the lessee of the adjacent private lands on which its well, the Hoffelt #2, is located.

The Miles City District Manager found that the Hoffelt #2 well was draining Federal lease M-60749 by a drainage factor of 4.4 percent. Citing lease provisions and applicable regulations, the District Manager assessed ARCO for compensatory royalties effective the date of first production from the Hoffelt #2 well and continuing until the date of last production, or the effective date of the relinquishment of affected portion(s) of lease M-60749, or the date on which production commences from a protective well. Production was first reported for January 1985, but since July 1, 1986, production from the relevant Gunton formation has been shut off. No protective well has been drilled by ARCO.

BLM urges this Board to reconsider Atlantic Richfield Co., arguing that the prudent operator rule, which is generally applied in diverse ownership cases, has been greatly modified (if applied at all) in common lessee cases. According to BLM, a number of courts have refused to apply the prudent operator rule when, as here, a common lessee is causing the drainage. BLM asserts that the basis for this distinction is the recognition of implied obligations beyond the mere duty to drill an offset well (Petition for Reconsideration, Feb. 6, 1989, at 10). BLM asserts that courts have recognized the contractual relationship created by a lease imposes a good faith obligation upon the lessee to refrain from any affirmative action which would deplete the leasehold property.

BLM contends that ARCO breached this implied duty (also known as the covenant not to deplete or impair) by draining Federal lease M-60749

through the Hoffelt #2 well, which is located on adjacent private lands. BLM states:

ARCO did not notify the BLM of its intent to drill, although the proposed well location was immediately adjacent to its Federal lease; it did not, prior to first production or any time thereafter, attempt to mitigate its losses or protect the Federal royalty interests through unitization or any other means, although its lease specifically requires it to pay royalties on production from the Federal tract; and, it has received the benefit of the reserves attributable to the Federal lease without having to incur the costs of an offset well.

Id. at 11.

ARCO, as the party in control of operations on both the producing and nonproducing leases, has more options for lease protection than might be available to a third-party lessee, BLM states. The common lessee knows where and when it intends to drill. BLM maintains that even if the common lessee wishes for sound business reasons to retain both leases and thereby prevent drilling or development in competition to its own activities, it may unitize the parcels so that the interests of its lessor on the undeveloped tract are protected. *Id.* at 12. BLM cites Williams v. Humble Oil & Refining Co., 432 F.2d 165 (5th Cir. 1970), for the proposition that the liability of a common lessee for compensatory royalties can be predicated as much on the lessee's failure to unitize or pool as upon a failure to drill offset wells.

It is possible, BLM states, that a common lessee might under some circumstances escape liability for payment of compensatory royalties if it

can show that it had taken all reasonable efforts to protect the lease from depletion. These facts are not present here, BLM maintains, because ARCO failed to notify BLM of its intent to drill and failed to unitize the private and Federal lease.

BLM acknowledges that requiring a common lessee to pay compensatory royalty, regardless of whether an offset well would be profitable, may often place the lessee in the position of paying double royalties on the drained reserves, *i.e.*, a royalty to the private lessor and a compensatory royalty to the United States (Petition for Reconsideration, *supra* at 16). A common lessee, however, has several options to protect itself from double royalties, BLM explains. These options include unitization and relinquishment of the lease. *Id.* Having made no showing of any attempt to protect itself by unitization, relinquishment, or other means, ARCO has little basis to complain, BLM states.

In response, ARCO argues that Atlantic Richfield Co. is supportable by the common law in a majority of oil and gas producing states. Courts have not made absolute the implied covenant to protect the lessor against drainage, ARCO states, but have properly considered this duty in the context of the expectations of the parties and the law of capture. It notes that one of the elements in a cause of action for breach of this covenant is the prudent operator standard, which requires a showing that a protective well could maintain sufficient production to yield a reasonable profit after paying all drilling, operating, and other burdens and expenses (Response to Petition for Reconsideration, July 5, 1989, at 5).

ARCO states:

The rationale for the [prudent operator] rule is that the lessor should not be placed in a more favorable position by bringing an action against the lessee for damages from drainage caused by adjacent production if the lessor would not have protected his mineral estate from drainage had his minerals remained unleased. A lessor should not be able to require his lessee to pay damages, drill an offset well, or relinquish the lease if the lessor, as an unleased mineral owner, would not be reasonably expected to make the capital investment required to prevent such drainage because a reasonable profit will never be recouped on such investment.

Id. at 6.

ARCO disputes BLM's view that the act of drilling a well on an adjacent parcel is an affirmative act which depletes the property of the Federal parcel. Cases using this language involve lessee actions to intentionally cause a migration of minerals, and such acts are generally motivated by a differential burden under the respective leases (Response at 15). ARCO maintains that the geologic conditions in the area dictated the location of its well, and that it located the Hoffelt #2 well on private lands, even though the royalty burdens placed on production on the private lands exceeded those of the Federal lease ^{1/} (ARCO's Response to BLM Answer, June 12, 1987, at 14).

^{1/} ARCO states that it pays royalties of 15.6837 percent on production from the Hoffelt #2 well (ARCO's Response to BLM's Answer, June 12, 1987, at 13). The royalties due on production from M-60749, a competitive lease, begin at 12-1/2 percent and increase to a maximum of 25 percent as average production per well per day increases. See Schedule B to lease M-60749.

In response to BLM's suggestion that ARCO could have protected the Federal royalty interest by informing BLM of its intention to drill, ARCO replies that it had no duty to notify BLM of its activities on private lands and that no regulation requires such notice. Responding to BLM's suggestion that unitization was available to protect the Federal royalty interest, ARCO states that BLM has failed to present facts showing that unitization was practical under the circumstances. BLM's arguments fail to recognize the complex nature of unit formation, ARCO contends, and offer no support for a duty to unitize (ARCO's Response to BLM's Petition for Reconsideration, supra at 16).

[1] After careful review of the pleadings filed by BLM and ARCO, we affirm Atlantic Richfield Co. We do so because this decision accurately reflects the majority position of courts that have confronted the issue whether a common lessee must pay compensatory royalty for draining its lessor. See 5 Williams and Meyers, Oil and Gas Law § 824 (1986). In addition, the majority position avoids the payment of double royalties by a common lessee who, as alleged here, locates its well on the basis of geology after concluding that reserves can support but one well. 2/

BLM maintains that the distinguishing factor making the prudent operator rule inapplicable to the instant case is the presence of an implied covenant to refrain from affirmative acts that would impair the value of

2/ Whether ARCO's conclusion was accurate is a question presently pending on remand. 105 IBLA at 229, 95 I.D. at 242. If an economic well could have been drilled, ARCO must pay compensatory royalties.

the lease. Case law does not support this view, however. Indeed, one of the cases cited by BLM in support of the implied covenant to refrain from depleting, Humphreys Oil Co. v. Tatum, 26 F.2d 882 (5th Cir.), cert. denied, 278 U.S. 633 (1928), appears to incorporate the prudent operator rule. ^{3/} Shell Oil Co. v. Stansbury, 410 S.W.2d 187 (Tex. 1966), leaves no doubt that a common lessee's duty to protect its lessor against depletion is limited by the prudent operator rule.

Moreover, we note that those cases holding the prudent operator rule inapplicable to common lessee drainage ignore the oil and gas industry practice of blocking up a large acreage before drilling. In Geary v. Adams Oil & Gas Co., 31 F. Supp. 830, 834 (E.D. Ill. 1940), which is frequently cited in the cases holding the prudent operator rule inapplicable, the court explains its departure from the prudent operator rule in these terms:

But here the mind is haunted by the fact that the defendant is the beneficiary of the oil drained from plaintiff's land by the wells on the north and south which belong to the defendant. It has not only been saved the cost of drilling, equipping and operating a protecting well but it gets the oil anyway without plaintiffs being paid for it.

Such a view makes the common lessee a guarantor of royalties to a lessor whose lands do not justify drilling. Double royalties result, and reserves remain unrecovered.

^{3/} See also Tide Water Associated Oil Co. v. Stott, 159 F.2d 174 (5th Cir. 1946), cert. denied, 331 U.S. 817 (1947), and 5 Williams and Meyers, Oil and Gas Law § 824 n.7 (1986), for a discussion of this case.

BLM's suggestion that a common lessee should be required to unitize tracts sharing a common reservoir finds support in Williams v. Humble Oil & Refining Co., *supra*, and offers some legal basis for compensating the lessor of the drained tract. It is clear that the Secretary can compel unitization in the case of offshore leases. *See Sun Oil Co.*, 67 IBLA 80 (1982). The Secretary can also prescribe a unit plan for development of an onshore field. *See* 30 U.S.C. § 226(j) (1982). However, there is nothing in the statutes or regulations which would compel a common lessee to seek unitization in cases such as this. Should BLM adopt such a view in its policy review 4/ and promulgate a regulation to that effect, lessees such as ARCO would have ample notice of a duty to unitize. In this way the lessor of a tract holding insufficient reserves to support a well could be compensated without the common lessee paying double royalties.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, Atlantic Richfield Co. is affirmed.

R. W. Mullen
Administrative Judge

I concur:

Bruce R. Harris
Administrative Judge.

4/ In its petition, BLM explains at page 6 that its drainage policies, as set forth in its interim Manual and Handbook, are not yet finalized.

